ANNUAL TRADE PROJECTION REPORT TO CONGRESS

Prepared Jointly by the Department of the Treasury
and the Office of the United States Trade Representative

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Annual Trade Projection Report - 1989

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PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains numerous reporting requirements, including, in Section 1641, a requirement for an Annual Trade Projection Report. The impetus for this report reflected widespread concern about the emergence of substantial U.S. trade and current account imbalances and the impact of foreign economic trends and policies on these imbalances.

The report is to include a review and analysis of key economic developments in countries and groups of countries that are major trading partners of the United States, projections for developments in various macroeconomic variables in the reporting year and the following year, conclusions and recommendations for policy changes to improve the outlook, and the impact on U.S. trade of market barriers and other unfair practices.

The legislation specifies that the report is to be prepared jointly by the Treasury Department and the Office of the United States Trade Representative, in consultation with the Chairman of the Board of Governors of the Federal Reserve System. The Report is to be submitted on March 1 of each year to the Senate Finance Committee and the Ways and Means Committee of the House of Representatives.

This is the initial report submitted pursuant to P.L. 100-418; Section 1641. Part II provides a review and analysis of recent macroeconomic developments in countries or groups of countries that are major trading partners of the United States, as well as a review of key recent developments in the U.S. economy. Part III presents projections for key macroeconomic developments in 1989 and 1990 in the same countries and country groups. The two main sections are organized as follows: Section 1 discusses economic growth, fiscal trends and current and trade account developments in the industrial countries; Section 2 reviews key developments elsewhere in the world economy, discussing the non-OPEC member Less Developed Countries (non-OPEC LDCs), including the Newly Industrializing Asian Economies (NIEs), as well as the OPEC countries. Part IV reviews the policy issues raised by these projections, and Part V discusses the impact on U.S. trade of market barriers and other unfair practices.

Readers are, in addition, referred to the Treasury Department's October 1988 Report to Congress on International Economic and Exchange Rate Policy, which discusses key issues, including exchange rate developments, in considerable depth and provides a more detailed review of important recent historical trends. That report was also completed under requirements in the Omnibus Trade and Competitiveness Act of 1988 (P.L.100-418).

PART II: REVIEW AND ANALYSIS OF RECENT DEVELOPMENTS

1. Developments in the Industrial Countries

Real economic growth in the industrial countries in 1988 was, for the most part, substantially stronger than had widely been expected, particularly in view of concerns raised by the financial market turbulence in the fall of 1987. In fact, average real GNP growth in the OECD group of industrialized countries strengthened to an estimated 4 percent in 1988, well above the average growth rate during the previous decade.

A. Key Developments in the United States

Because economic developments in the United States are such an important determinant of performance elsewhere in the industrial country group, a brief review of these developments will help put the subsequent discussion in context. Real GNP growth in the United States rose from 3.4 percent in 1987 to 3.8 percent in 1988 on an annual average basis, but slowed from 5.0 percent to 2.7 percent when measured on a fourth quarter over fourth quarter basis, i.e., the fourth quarter of 1988 versus the fourth quarter of 1987. (The latter measurement helps assess the trend rate of growth during the course of the year -- accelerating or slowing down -- though it is also more sensitive to developments in the starting and ending quarters.)

However, this general picture of slowing growth in the United States in 1988 is misleading given the substantial depressing effect of last year's drought. When the GNP data are adjusted for the drought a rather different picture emerges: U.S. real GNP growth improved even more strongly on an annual average basis, to 4.1 percent, and slowed less substantially on a 4th/4th basis, to 3.3 percent. The drought adjustment is particularly striking on the 4th/4th basis because of the greater negative impact of the drought on GNP during the second half of the year.

The effects of the ongoing reduction of the U.S. trade and current account deficits are clearly evident in the national accounts. (Note: There are two basic measurements of the external side of any economy. The balance of payments, i.e., the trade and current accounts, measures the nominal dollar value of international transactions in goods (trade account) and goods and services (current account). The national income and product accounts (the NIPA or GNP accounts) incorporate the external side of the economy by including exports and imports of goods and services on a real, i.e., price-adjusted, basis. Thus, by separating the domestic side of the economy (i.e., private and public

consumption, and investment) from the external side (exports and imports), and by presenting both in price-adjusted terms, the NIPA measurement identifies the relative contributions of each to the overall real growth performance.)

Domestic demand growth in the United States was 3.0 percent in 1988, unchanged from its 1987 growth rate. Thus, GNP growth exceeded domestic demand growth by a substantial margin in both 1987 and 1988. As explained above, this gap illustrates the net positive contribution of the external side to overall U.S. growth since 1986. In 1988 the strong real improvement in exports of goods and services added a total of about 0.8 percentage points to real GNP growth; thus better net exports produced about 20 percent of total U.S. growth last year even though exports account for only about 13 percent of overall real GNP. So looked at from the standpoint of the NIPA, the U.S. external adjustment process continued, and indeed strengthened, in 1988.

Adjustment is also clearly evident when measured on a balance of payments basis. As noted in the summary above, the U.S. trade deficit was reduced by an estimated $35 billion in 1988, and the current account deficit by about $20 billion. Expressed as a percent of GNP, which facilitates international comparisons of countries of different size, the U.S. current account deficit narrowed from 3.4 percent in 1987 to 2.8 percent in 1988.

The bulk of the improvement in the U.S. trade deficit in 1988 occurred against the industrial countries (about $20 billion), which collectively absorb 64 percent of total U.S. exports. Within this group, the U.S. deficit vis-a-vis Western Europe (27 percent of total U.S. exports) was cut by more than half, from $27 billion to $13 billion: the U.S. deficit with Germany fell by about $3 billion due entirely to higher exports; and the U.S. trade balance with the U.K. improved by nearly $4 billion, to a small surplus. The balance of U.S. trade with the EC shifted by $12 billion, from a deficit of $21 billion to a deficit of $9 billion. The U.S. trade account improvement against Japan (which accounts for about 12 percent of U.S. exports and 20 percent of U.S. imports) was about $4 billion.

There was also a considerable decline in the U.S. trade deficit with the developing countries in 1988. Against this group, which accounts for 33 percent of U.S. exports (i.e., more than Western Europe), the U.S. deficit narrowed by $13 billion, from $59 billion in 1987 to about $46 billion last year. The U.S. trade deficit with Mexico (the third largest U.S. export market after Canada and Japan) fell by $3 billion; however this shift was partly offset by a $1 billion increase in the U.S. trade deficit with Brazil.

Roughly half of the U.S. deficit shift against the LDCs was accounted for by a $5.5 billion decline in the deficit with the Newly Industrializing Economies of Asia. (This group accounts for 11 percent of U.S. exports and 14 percent of U.S. imports.) The bulk of this improvement came against Taiwan, with which the U.S. deficit fell from $17 billion to $13 billion. Against Korea, on the other hand, the U.S. deficit was virtually unchanged.

Finally, the U.S. deficit with the OPEC countries was reduced by $4 billion due mainly, and perhaps surprisingly given the general slowdown in OPEC import growth, to higher U.S. exports; given oil price developments in 1988 U.S. imports from OPEC were reduced by about $1 billion.

B. Developments in Other Industrial Countries

The accelerated economic growth in the industrial countries in 1988 was due to a number of factors. First, consumer and business sentiment improved dramatically during the first half of 1988, rebounding from the excessive pessimism that had prevailed in the wake of the October 1987 financial market events. The effect of this shift was seen in private consumption spending, which was clearly stronger than initially expected, and, most importantly, in substantially higher real investment spending. Second, the rate of growth of world trade jumped by about 50 percent in volume terms (from nearly 6 percent in 1987 to an estimated 9 percent in 1988) both reflecting and at the same time contributing to stronger overall industrial country growth. Third, some special factors -- like a mild winter and extra work days in Europe -- gave growth rates an early boost in 1988.

As noted above, stronger investment activity in 1988 contributed importantly to the general improvement in domestic demand growth in the industrial countries outside the United States. In fact, gross investment spending increased in real terms in each of the six foreign Summit countries (Japan, Germany, France, U.K., Italy and Canada), in some cases (Germany and the U.K.) dramatically. In the 12 EC countries as a group investment growth rose from about 4.5 percent in 1987 to an estimated 7.5 percent last year, an unexpectedly good result that was generally shared by the other European countries.

Developments in another key domestic demand component, private consumption, however, were less uniform. Consumption growth rates picked up in Japan, the U.K. and the Netherlands, remained essentially unchanged in France, and generally declined in the rest of the group. For the EC as a whole, private consumption growth is estimated to have declined marginally in 1988 but, at about 3.5 percent, still remained well above average growth rates in the first half

of the decade. Although it is difficult to generalize, these declines to some extent reflected the impact on real earnings of wage restraint and somewhat higher inflation.

Taken together these trends indicate that in addition to the quantitative improvement in economic growth in our major industrial trading partners in 1988, there was some further qualitative improvement as well. Specifically, the gap between domestic demand growth and overall GNP growth in the key surplus countries -- an important determinant of the speed of trade and current account adjustment -- widened, particularly in Japan.

In aggregate, average domestic demand growth in the six foreign Summit countries rose from an annual average of 4.3 percent in 1987 to an estimated 5.5 percent in 1988. Average GNP growth was 3.4 and 4.4 percent, respectively; thus the domestic demand versus overall growth gap for this country group remained at about 1 percent in real terms. The same general picture applies to the EC group as a whole, while in the smaller European economies domestic demand growth is estimated to have exceeded GNP growth by about half this amount.

Turning to country specifics, Japan was again the Summit country growth leader in 1988 with its real GNP growth rate increasing from 4.5 percent in 1987 to an estimated 6.0 percent. Domestic demand (specifically, private consumption and investment) was again clearly the driving growth force, expanding by nearly 8 percent in real terms. The picture for Germany is similar, but less impressive. Overall GNP growth picked up strongly in 1988 (to about 3.6 percent) after a disappointing 1.8 percent advance in 1987. Bolstered mainly by investment, domestic demand growth rose from 3.1 percent in 1987 to an estimated 3.9 percent in 1988. The gap between domestic demand and GNP growth in Germany thus narrowed considerably, from 1.3 percent in 1987 to 0.3 percent in 1988.

Domestic demand growth in the U.K was appreciably stronger in 1988 (perhaps 5.8 percent), driven in large part by surging investment. In Canada and Italy domestic demand growth also led GNP in 1988; in France and Belgium both advanced by about 3.5 percent, while in the Netherlands growth rates were a more modest 2.5 percent.

Thus, in the important Summit 6 group as a whole (which, due entirely to Japan and Germany, is running a substantial combined current account surplus), the external side of the economy exerted a net drag on growth in 1988; i.e., net exports of goods and services declined in real terms. For both Japan and Germany this was the third consecutive such annual adjustment. (In the United States, conversely, improving net exports have been a positive contributor to GNP growth since 1987.)

B. Fiscal Balances

The fiscal deficits of industrial country governments were, in aggregate, generally reduced in 1988 due largely to the automatic stabilizer effects of the stronger economic growth described above. Specifically, higher growth and corporate profits tended to boost tax revenues while, on the other side of the budget accounts ledger, outlays for public support programs such as unemployment insurance tended to grow more slowly or even decline. For the most part, therefore, the fiscal tightening in 1988 appears to have been mainly cyclical rather than structural.

Calculations by analysts with the Organization for Economic Cooperation and Development (OECD) indicate that underlying fiscal policies in the industrial countries were mildly contractionary in 1988 after having been mildly expansionary in 1987. The OECD estimates that the 'cyclically-adjusted' overall fiscal position of the Summit 6 moved toward surplus by about 0.2 percent of GNP in 1988 after having eased by 0.3 percent of GNP in 1987. That is, when adjusted for the effect of automatic stabilizers (fiscal drag) plus discrete policy changes, the combined general government fiscal position (i.e., including all levels of government) of the six countries swung from slight stimulus in 1987 (0.3 percent of GNP) to slight contraction in 1988. Over the two year period, therefore, underlying fiscal policy in the Summit 6 group was essentially neutral. The OECD also estimates that the same figures apply to the European economies in aggregate.

There were, however, some important differences among countries. In Japan, the effects of a large increase in public investment and a late-1988 income tax cut were countered by higher growth-related revenues, resulting in a slight increase in the small (0.4 percent of GNP) general government surplus. In Germany, income tax cuts that came on stream in January 1988 helped boost the general government deficit somewhat, to an estimated 2.1 percent of GNP in 1988. However, after several years of contractionary policies the German deficit, expressed as a percentage of GNP, still remains well below levels recorded in the early 1980s.

The general government fiscal position continued to improve in the U.K. in 1988, with the surplus rising to 1.4 percent of GNP; expenditures have remained within fairly restricitve targets while revenues have benefitted from strong growth and privatization receipts. Elsewhere, the general picture is one of continued efforts to restrain expenditure growth coupled with better than anticipated revenues, producing deficits in 1988 that were somewhat reduced relative to GNP.

C. External Accounts

Although developments in the external accounts of individual industrial countries in 1988 were typically divergent, it is clear that in important respects progress continued to be made toward achieving better international balance. The U.S. trade and current account deficits were reduced in both nominal terms and as a percent of GNP. The counterparts to this U.S. adjustment in 1988 are found in lower external surpluses in Japan, the EC (and Europe more broadly), and the Asian NIEs.

Japan's current account surplus declined from $87 billion in 1987 to $79.5 billion in 1988, reflecting both a decline in the trade surplus and an increase in the invisibles deficit. The key development on the trade side was a very strong surge in import volume (about 16 percent) compared with export volume growth estimated at about 4.5 percent. However, with total exports running at nearly twice the level of total imports, the trade surplus was reduced by less than $1 billion in dollar terms (to $96 billion).

Canada's 1988 merchandise trade account netted out to a surplus of about $7.2 billion, down about $1 billion from 1987, as the real growth rates of both imports and exports picked up. However, with the traditionally large invisibles deficit running below its 1987 level, the current account deficit narrowed to an estimated $7 billion.

The combined current account surplus of the European Community dropped from about $37 billion in 1987 to an estimated $15 billion in 1988. However, there were important differences in the performance of specific member countries. The most striking development was a nearly sixfold increase in the current account deficit of the U.K., from $4.4 billion in 1987 to an estimated $25 billion in 1988. Lower oil earnings were partly responsible, but the bulk of the shift was accounted for by a surge in imports of investment goods.

Germany's trade surplus, on the other hand, reached a new record in DM terms (equivalent to an estimated $73 billion) due mainly to much stronger investment goods exports to the other EC countries. As a result, the German current account surplus rose by about $4 billion to nearly $49 billion (Germany is running a large and growing invisibles deficit), though relative to GNP it declined slightly to 3.9 percent.

Current account patterns within the rest of the EC remained little changed in 1988. France's deficit rose slightly to about $4.5 billion but remained quite small as a share of GNP, as was essentially the case for Italy.

Elsewhere within the EC, as well as in Europe as a whole, there were few remarkable developments: the combined deficit of the Nordic countries remained little changed (about $9 billion); the combined Benelux surplus rose from $6 billion to approximately $9 billion; and newly admitted EC member Spain slipped into deficit.

2. Developments Outside the Industrial Countries

Growth developments in the Less Developed Economies (LDCs) as a group were broadly satisfactory in 1988, though in contrast to the industrial countries, overall real growth was somewhat slower than in 1987. Specifically, the GNP weighted average real growth rate of the 137 non-OPEC LDCs tracked by Treasury analysts slowed from about 3.7 percent in 1987 to a provisionally estimated 3.1 percent last year.

As usual, however, there were important differences among countries and country groups, with the overall average strongly affected by developments in a few of the largest economies. Average real growth slowed in Latin America but remained quite strong in the Newly Industrializing countries of Asia.

In fact, the overall LDC growth slowdown in 1988 was due almost entirely to negative developments in a few Latin American economies. Specifically, Brazil registered zero real growth in 1988 (after 2.9 percent in 1987) and Mexico's growth rate slipped from about 1.5 percent in 1987 to an estimated 0.5 percent in 1988. As a result, in Latin America as a whole aggregate GNP growth slowed from 2.5 percent in 1987 to 1.4 percent in 1988. Elsewhere, the non-OPEC LDC real growth performance was about on par with 1987 rates, i.e., just under 4 percent.

The Newly Industrializing Economies of Asia (NIEs; Taiwan, Korea, Singapore, Hong Kong) were again the clear growth leaders, recording a weighted average growth rate of about 10 percent in 1988 after a similar outturn in 1987: Korea's growth rate remained at roughly 12 percent while Taiwan's slipped to a still impressive 8 percent.

The aggregate non-OPEC LDC current account balance registered a small $1 billion deficit in 1988 after a $4 billion surplus in 1987. As with the growth figures discussed above, however, there were sharp differences among individual countries and regions.

The combined current account surplus of the Asian NIEs declined by an estimated $5 billion in 1988, to about $26 billion. This correction was due entirely to a halving of Taiwan's surplus, from about $18 billion in 1987 to an estimated $9.6 billion in 1988; however, about $4 billion of this correction was due to special, and probably one-time, gold purchases. Korea's surplus, on the other hand, rose further to approximately $14 billion.

Other key current account developments within the non-OPEC LDC group were: a dramatic deterioration in Mexico's position, which shifted from a $3.4 billion surplus in 1987 to a $3 billion estimated deficit in 1988; a substantial opposite move in Brazil's current account, which shifted from about a $1 billion deficit in 1987 to a provisional $4.4 billion surplus in 1988.

Despite the important current account shifts within individual countries, the combined current account position of Latin America as a whole has actually changed relatively little in dollar terms in recent years. A $17 billion deficit in 1986 was reduced to $11 billion in 1987, where it remained last year.

The four Asian NIEs (Korea, Taiwan, Hong Kong, and Singapore) have become particularly significant players in the international trading system. Since 1970, their share of world exports has more than tripled to 7.4 percent. Moreover, these economies have in aggregate, accumulated external surpluses that account for a significant share of current global imbalances. Taiwan and Korea have recently been running large current account surpluses -- two to four times those of Japan and Germany as a proportion of GNP. (It should be noted, however, that Korea ran a current account deficit as recently as 1986.)

The factors that are responsible for the growth of the Asian NIEs' external surpluses vary among the individual countries and generalizations are difficult. Some important elements are relative advantages in costs of production and an emphasis on export production at the expense of domestic consumption and improved living standards. The expansion of world trade, and of the U.S. economy especially, has of course benefitted the NIEs, though this applies to the rest of the world as well. Undervalued exchange rates have also been a major factor in the cases of Korea and Taiwan.

The 13 member OPEC group collectively experienced a substantial increase in its current account deficit in 1988 as earnings from oil and gas exports were reduced significantly by the roughly 20 percent decline in the average dollar price of OPEC oil. After the deficit narrowed from $26 billion in 1986 to under $11 billion in 1987, it about doubled in 1988 to $20 billion. (Although the OPEC group typically runs a substantial trade surplus, it has been highly volatile in recent years and is significantly exceeded by a large deficit on invisibles transactions.)

PART III: PROJECTED DEVELOPMENTS IN 1989 AND 1990

Before reviewing projections for this year and next, it is important to set forth several key assumptions on which the analysis is based. First, all projections for individual countries and groups of countries are based on current policies. For the United States it is assumed that the federal budget deficit is reduced along the Gramm-Rudman-Hollings path. No assumptions are made as to how fiscal or monetary policies may be altered during the forecast period. Secondly, exchange rates are assumed to remain constant in nominal terms at current levels. Finally, the Administration's forecasts for the U.S. economy contained in the budget provide the basis for the U.S. outlook -- itself an important factor in the economic performance of the major U.S. trading partners.

As a result of these various basic assumptions, the projections discussed below are not "best guesses" of what the economic situation will turn out to be in 1989 and 1990. They are, rather, "best guesses" of what the situation will be <u>unless</u> policies change.

Latest forecasts and economic data indicate that the current economic expansion in the industrial countries is expected to continue through 1989 and 1990, its seventh and eighth consecutive years. However it is widely expected that the pace of overall growth will be at a somewhat slower rate than in 1988. As was the case in 1988, world trade growth should continue to outstrip real GNP growth substantially, providing support for the ongoing external adjustment process as well as a firm foundation and stimulus to overall growth. Inflation in the industrial world is, on average, expected to remain moderate through 1990. It is more difficult to generalize regarding fiscal side developments: many countries will continue to pursue, with varying intensity, policies designed to reduce budget deficits and public borrowing requirements. However, it is also true that tax reform and the overall reduction of tax burdens remains a policy objective in numerous other countries.

1. Projections for the U.S. Economy

The U.S. economy is expected to continue to expand along a sustainable growth path this year and in 1990. After last year's partially drought-influenced growth slowdown, GNP growth (on the 4th/4th basis) is officially forecast to pick up to about 3-1/2 percent in 1989 and to remain at roughly this rate in 1990. (Note: This 1989 growth rate tends to overstate the underlying growth momentum of the economy due to the negative end-1988 impact of the drought discussed above.)

U.S. growth rates on an annual average basis are likely to be a bit lower, but still in the 3 to 3-1/2 percent range in both years. Domestic demand growth rates are forecast to remain in the 2-1/2 to 3 percent range. Thus the external side will remain a net positive contributor to overall growth, with real increases in exports expected to exceed import growth substantially. On the balance of payments basis, further declines in the U.S. trade and current account deficits are expected; however, given rising debt service costs there will not be a full pass-through of the trade deficit reductions to the current account.

2. Projections for the Other Industrial Countries

A. Economic Growth

Real economic growth in the industrial countries is expected to slow somewhat this year, to the 3.0-3.5 percent range, i.e., returning to the rate recorded in 1987. Largely responsible for this moderate slowdown will be an anticipated return of investment growth to a more measured rate in 1989 after its unusual strength in 1988. While 1990 is a bit beyond the normal projection horizon, preliminary work suggests a further, though more modest, growth slowdown in the major foreign industrial countries. It is anticipated that aggregate real growth in the Summit 6 countries will be just under 3 percent on average in 1990.

There is broad agreement among forecasters that German real GNP growth will fall back somewhat this year from last year's sharply higher rate, mainly reflecting the dampening effect of various tax increases on disposable income and private consumption growth. Japanese growth should also slow this year, though for different reasons and to a rate that will still be well above that of the other Summit economies. Specifically, private consumption growth in Japan should remain quite robust while investment growth -- an especially dynamic factor in 1988 -- cools considerably.

Given Germany's size and the impact of its economic policies on other EMS countries, it is not surprising that the aggregate growth performance of the four largest European economies (Germany, France, U.K., and Italy) will not diverge much from the German trend. The U.K. is unlikely to maintain the very strong investment and private consumption growth rates recorded in 1988 in the face of recent monetary policy tightening; real GNP growth in the U.K. is expected to fall back to a more sustainable rate. France did not experience similarly exceptional developments in 1988, but both consumption and investment rates nevertheless appear likely to cool this year.

Prospects for the rest of Europe, within and outside of the EC, are broadly similar: slower real GNP and domestic demand growth due in part to a return of investment to lower growth rates. Specifically, GNP growth in the non-Summit European countries is expected to slow by about one half a percentage point, to 2-3/4 percent.

Domestic demand growth in the six foreign Summit countries should, in aggregate, continue to outpace that of overall GNP growth. However, the extent to which domestic demand growth exceeds GNP growth is likely to narrow significantly this year. In addition, there are important differences among the countries. Taken together, domestic demand growth in the four major European countries (and in the smaller European countries as well) is expected to be roughly the same as GNP growth, just under 3 percent.

The disappearance of the domestic demand/GNP growth gap within the Europe Big 4 this year is expected to be shared broadly. In Germany, France and the U.K. domestic demand growth rates will drop substantially, though for the different reasons mentioned above, pulling overall GNP growth down with them. From a trade adjustment perspective the possible elimination of this gap suggests that limited further progress may be made this year toward adjusting the aggregate Europe Big 4 trade imbalance. In Japan, in contrast, domestic demand growth is forecast to continue to exceed GNP growth though here too the gap is expected to narrow relative to 1988.

At this early forecasting stage analysis suggests continued moderate overall GNP growth in the industrial countries in 1990, which is potentially the eighth consecutive expansion year. However, while the general growth picture appears reasonably satisfactory in a quantitative sense, it is less so in a qualitative one. Specifically, our projections indicate that the pattern of domestic versus overall growth is not likely to be much different from this year's.

For the foreign Summit Six, GNP growth is expected to slow moderately, to just below 3 percent. Growth rates in the two largest foreign economies, Japan and Germany, are both expected to slow somewhat further, though for different reasons. Despite the enactment of the final stage of a multi-year tax reform in Germany, tax cuts amounting to about 0.5 percent of GNP are not expected to boost private consumption significantly. Consumption growth is likely to be restrained by an increase in the savings rate, and investment growth will probably slow after two relatively strong years. If these views are borne out, German GNP growth could subside to the bottom end of growth in the foreign Summit countries.

In Japan, on the other hand, private consumption growth is likely to continue at roughly its 1989 pace, but a fairly substantial slowdown in plant and equipment investment is expected. Nevertheless, Japan's projected 1990 GNP growth rate is likely to remain well above the Summit Six average.

Growth rates are also likely to slow a bit further in Italy and France, the other two major continental European economies. In the U.K. by contrast, real GNP growth may well strengthen in 1990 as exports continue to improve and private consumption rebounds from what is expected to be weaker growth this year.

At this juncture, it is expected that the rest of Europe will be on a roughly 2-1/2 percent growth path in 1990. Spain, Portugal and Turkey are again likely to be the top growth performers, while real growth in Denmark and Sweden should remain relatively slow. The aggregate growth rate of the EC will of course be driven largely by developments in the four major economies, and thus is likely slip to about 2-1/2 percent.

B. Fiscal Balances

If budgetary policies remain as presently anticipated -- as must be assumed -- the aggregate fiscal stance of the OECD as a whole (again, cyclically adjusted) will be broadly neutral over the 1989-1990 period. Nevertheless, there will be some significant differences among the individual countries. Fiscal policy in the United States will be geared toward meeting statutory requirements for reducing the federal deficit. In Japan, the fiscal deficit is likely to rise moderately, reflecting the combination of a variety of tax changes with a modest rise in government expenditures. Germany's planned policy over the period combines an array of tax and social payment increases this year with further income tax reductions in 1990. The overall German government budget deficit (as a percent of GNP) will therefore decline in 1989 and rise in 1990; but over the 1989-90 period its average will be well below that of the 1987-88 period.

The U.K. shifted to a budgetary surplus in 1988, despite tax cuts, and, relative to GNP, is likely to show moderately rising surpluses in 1989 and 1990. France has combined higher outlays on selected domestic programs with reduced corporate and excise taxes, but little overall change is expected in its relatively small deficit. On present policies the general government deficit in Italy will remain essentially unchanged and relatively high as a percent of GNP (11.5 percent in 1988). Similarly, little change is anticipated in the Canadian budget deficit through 1990.

The smaller European countries have been steadily reducing public deficits as a percent of GNP since the early part of the decade, and this trend is expected to continue. Specifically, the average deficit is likely to be held below 2 percent this year and next, compared with a 5 percent level in 1983.

C. External Accounts

Current account projections for the industrial countries in 1989 and 1990 indicate that the external adjustment process should continue, albeit with less uniform improvement than might be desired. World trade flows will, of course, be driven importantly by the growth trends discussed above. Thus, with aggregate industrial country growth expected to slow moderately in 1989 and 1990, so too should the real expansion (i.e., volume growth) of trade. Nevertheless, trade volume growth in the OECD countries should still remain fairly robust and again outstrip GNP growth by more than a 2:1 margin. Indeed, average trade volume growth over the 1988-90 period should prove to be higher than in any three year period since the mid-1970s.

Preliminary projections indicate that the combined current account surplus of the Summit 6 countries will decline this year and again in 1990. Specifically, after an estimated surplus of $88 billion in 1988, the Summit 6 total surplus is forecast to fall to about $74 billion in 1989 and $64 billion in 1990. This implies that the group's combined surplus will have been nearly halved since its record high of $123 billion in 1986.

The largest shift should be seen in Japan, whose current account surplus is expected to drop significantly from about $80 billion last year. Roughly half of this projected decline is accounted for by a decline in the (dollar value) trade surplus, with the remainder accounted for by an increase in the Japanese services and transfers deficit.

Germany, however, presents a different picture. With export growth having rebounded from a brief slump in 1987 (due in the main to the commodity composition of German exports and the stronger foreign demand for investment goods), the German trade surplus is likely to rise moderately through 1990. Thus, despite an expected increase in its traditional invisibles deficit, Germany's current account surplus will probably remain broadly unchanged. On a regional basis, the key feature of the German trade account has been a sharp increase in its surplus with other EC countries, and this is expected to persist.

Elsewhere within the Summit 6, no dramatic changes are anticipated. Last year's ballooning of the U.K.'s trade (and current account) deficits is not likely to be reversed

by 1990. France, Italy and Canada should collectively have about the same current account deficit in 1990 as they had in 1988.

The smaller OECD countries should, in aggregate, experience an increase in their relatively small combined current account deficit due largely to an expected increase in Spain's deficit. Among the others, surpluses and deficits are fairly minor in dollar terms, and no substantial shifts are anticipated. Thus, current account trends in the OECD as a whole through 1990 will essentially track developments in the largest seven economies.

2. Projections for the Non-Industrial Countries

The developing countries should post somewhat higher aggregate real growth in 1989 and remain on a fairly even keel in 1990, aided by the expected continued moderate growth in the industrial countries. Trends in Latin America will again be dominated by developments in Mexico and Brazil. In both cases, current trends suggest a modest growth rebound this year, with somewhat higher real growth in Argentina as well. Thus for the region as a whole, we anticipate a return to the 3-1/2 to 4 percent growth range through 1990.

Growth prospects for the Asian NIEs remain quite good. Although the two biggest economies, Taiwan and Korea, are likely to experience a slowdown from their recent double-digit rates, growth should remain at about 9 and 7 percent, respectively. These projections imply aggregate NIE growth rates in the 7 to 8 percent range this year and next. Contributing to this slower growth scenario will be a reduced rate of export expansion and an increase in the growth rate of imports. The NIEs traditionally pursue relatively conservative fiscal policies, which implies little direct growth stimulus from the public side and continued fiscal surpluses.

Assessing recent economic growth developments in the OPEC group, and producing credible projections for the future, is extremely difficult in view of serious data problems with two of the largest countries, Iran and Iraq, and oil price uncertainty. We do not disagree fundamentally with the latest IMF staff projections, which suggest that average growth for the group is likely to improve from about 1 percent in 1988 to about 2 percent in 1989. Obviously, the picture for this year and next will be importantly affected by oil price developments. If oil prices remain around current levels (which is but one of several alternative scenarios), and barring any exceptional developments, aggregate OPEC growth in 1990 could again be be within the 1-1/2 to 2 percent range.

The aggregate current account deficit of the non-OPEC LDCs is forecast to expand this year, from an estimated $29 billion in 1988 to about $39 billion. About half of this shift is expected it be accounted for by a decline in the combined surplus of the NIEs; the remainder reflects a projected $2 billion increase in the Latin American deficit and scattered increases throughout the rest of the non-OPEC LDC group.

Current account developments in the NIEs will, as usual, be dominated by Korea and Taiwan. Korea's large surplus is expected to narrow somewhat this year given the already emerging trends of slower export and stronger import growth. In Taiwan, the adjustment that was already underway in 1988 should continue this year, reducing the current account surplus further. This projection, however, depends importantly on greater import penetration. In both countries additional surplus reductions are anticipated in 1990, though they might not be as substantial as this year.

Given these basic projections for the two largest economies, the combined current account surplus of the NIEs as a group should show further declines in both 1989 (to $21 billion) and 1990 (to $18 billion). These current account projections however tend to obscure a somewhat stronger underlying adjustment process in the trade accounts alone. Both Korea and Taiwan are running growing surpluses on the invisibles account (services and transfers) which partially offsets reductions in merchandise trade surpluses. Thus while we expect a $8 billion reduction in the combined NIE current account surplus between 1988 and 1990, the projected reduction in the merchandise trade deficit is $11 billion. If our projections are borne out, the overall trade surplus of the NIEs in 1990 will drop below $10 billion.

Key developments shaping the combined Latin American current account deficit in 1989 and 1990 are: substantially reduced surpluses in Brazil relative to 1988; and marginally lower deficits in Mexico. In aggregate, Latin America's current account deficit is forecast to widen slightly (to $13 billion) in 1989 and then narrow slightly (to $11 billion). In light of the projected industrial country growth and trade trends outlined above, we do not anticipate any dramatic developments on the trade side. The Latin American region's combined trade surplus is expected to remain little changed, in the $27-28 billion range.

Current account developments in the OPEC countries in 1989/90 will of course turn importantly on the situation in the world oil market and the extent to which these producers are able to affect it. With industrial country growth expected to slow this year and next, and given excess worldwide production capacity, neither demand nor supply-side considerations suggest strong price pressure developing in the near-term. A marginal rise in the OPEC trade surplus would cut its combined current account deficit commensurately.

PART IV: POLICY ISSUES

The basic near-term policy objectives for the industrial countries, particularly those with large external imbalances, will remain what they have been for the past few years. Together they need to ensure that real growth continues at a steady, solid pace, that inflationary pressures are contained, and that the external adjustment process remains on track in the context of a healthy and growing international trade and financial system. These goals apply as well to the non-industrial countries.

There is no controversy about these general objectives. Indeed, they reflect a clear international consensus and have been endorsed often and in considerable detail by participants in the annual Economic Summit meetings, the regular meetings of the Summit country Finance Ministers and and Central Bank Governors, and the semi-annual meetings of the IMF's policy-making Interim Committee.

There are of course inevitable differences of view about the relative importance of the various objectives, and about the best means of achieving them. In order to discuss and help resolve these differences, the summit countries have developed and strengthened the process of coordinating their economic policies. International economic policy cooperation has been a central theme at the past three Economic Summits (Tokyo in 1986, Venice in 1987, Toronto in 1988) and will again be so at the upcoming 1989 Summit in Paris. (This process was reviewed in considerable detail in the October 1988 Treasury Department Report to Congress on International Economic and Exchange Rate Policy, and readers are referred to that report for a full discussion.)

The policy coordination process has produced a clear and solid consensus on the basic elements of achieving the shared objective of reducing external imbalances while remaining on a sustainable growth path. At the broadest level, continued adjustment requires supportive international macroeconomic developments. The industrial countries need to remain on a non-inflationary growth path to stimulate world trade and provide growing markets for their own exports and the exports of the LDCs that are striving to meet the objectives of debt management, growth and development.

The participants are committed to the basic policy course necessary to translate these objectives into real progress. The United States, for its part, is committed to substantial federal budget deficit reductions, improving its international competitiveness, and bolstering its savings rate. For the countries with large external surpluses -- particularly Japan and Germany -- this means implementing macroeconomic and structural policies to ensure open,

growing domestic markets. Essentially, domestic demand growth in the surplus countries must be strong enough to compensate for the contractionary effect of declining surpluses.

There has been a growing recognition, however, that most economies suffer from structural impediments to growth and adjustment which diminish the effectiveness of fiscal, monetary and exchange rate policies. Hence the scope of the coordination process has been expanded to include, in addition to the traditional focus on macroeconomic policy, specific examination of the complementary role that structural reforms can play. At Toronto each of the participating countries agreed to specific structural reform steps including, inter alia: reducing labor market rigidities that inhibit flexibility and prolong high unemployment; cutting subsidies that impede the efficient flow of resources both domestically and across international borders; reforming tax systems that discourage risk-taking and innovation and supress demand; liberalizing financial markets; and, reducing burdensome regulations and excessive public intervention in private sector activities.

Thus the policy coordination process is an evolving one. By specifically incorporating macroeconomic and structural considerations, and by examining the broader consequences of individual policy choices, it is well suited to producing medium-term solutions to what are, after all, medium-term problems.

The need for appropriate macroeconomic and structural policies is not, however, limited to the industrial countries. The LDCs also have an essential role to play. For example, the NIEs need to permit their exchange rates to move in line with market forces and the underlying strength of their economies in order to contribute to more balanced trade flows and further global adjustment. Other policy changes in the NIEs, including structural reforms to give greater emphasis to domestic demand as a source of growth and, in the cases of Korea and Taiwan, measures to liberalize trade and capital flows are also necessary. Since mid-1986, the United States has conducted discussions with the four -- most intensively with Korea and Taiwan -- about these issues. In addition, the OECD is exploring ways to open an informal dialogue with the NIEs, focussing on mutual responsibilities to promote open markets for trade, investment and other financial transactions.

As a general matter the LDCs, and especially the heavily indebted economies, need to ensure that their policies support domestic growth and capital formation, reduce inflation, and encourage appropriate financial support from the commercial banks and the international financial institutions. Resolving the serious imbalances in these

economies is a major medium-term challenge that will require sound policies in both the macroeconomic and structural areas.

Fiscal deficits and monetary creation must be brought under control, capital flight must be halted and investment policies must encourage return of overseas funds to bolster domestic investment, distortions of relative prices -- as well as interest and exchange rates -- must be reduced, excessive regulation and public sector intervention should be eliminated, and trade policies should encourage greater integration with the global trading system.

Fortunately, there is growing evidence that the LDCs recognize that market-oriented policies hold the greatest promise for growth, development and global economic integration. In addition to encouraging this emerging shift in attitudes, it is essential for the industrial economies to provide material support by maintaining open and growing markets, reducing distortions in the global trading system and providing appropriate support for the international financial institutions. The policy coordination process is an integral part of this larger effort.

PART VI: IMPACT OF TRADE BARRIERS

The Congress requires the reporting of foreign barriers to U.S. trade in the National Trade Estimate Report as revised by Section 1304 of the Omnibus Trade and Competitiveness Act of 1988. The law also requires quantification, where feasible, of the estimated effects of individual barriers to U.S. exports of good and services and on U.S. foreign direct investment. This report is due and will be sent to the Congress by April 30, 1989.

Because of the two-month interval between the mandatory submission dates for the two reports, the National Trade Estimate Report is only now in preparation as this Annual Trade Projection Report is being finalized. For a listing of foreign trade barriers and their impact on U.S. trade and foreign direct investment, the Congress is, therefore, referred to the forthcoming National Trade Estimate Report.

Care should be exercised in the interpretation of the impact of foreign barriers on U.S. trade and investment. Specific trade barriers can and do have a substantial impact on exports, imports, production and trade balances for specific products and, to a lesser extent, for specific U.S. bilateral trade relationships. However, trade barriers have relatively little impact on the aggregate imbalance in U.S. trade.

Summing the estimated trade effects of individual trade barriers would overestimate the impact on aggregate U.S. exports of eliminating foreign trade barriers. By definition, the "partial equilirium" analysis in which trade barrier effects usually are estimated precludes drawing any derivative implications of specific trade barriers for the aggregate trade balance.

Trade barriers are important because they introduce microeconomic inefficiencies (resource misallocation) at the national and international levels and impose economic welfare costs on societies. However, their effect on aggregate trade balances or the projection of aggregate balances is limited.